Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Charles W. Cullen III, CIM, CFP
Senior Portfolio Manager
& Wealth Advisor
Tel: 902-424-1092
charles.cullen@rbc.com

Cullen Wealth Management
of RBC Dominion Securities
1959 Upper Water St., Suite 1400
Purdys Wharf Tower I
Halifax, NS B3J 3N2
www.cwcullen.com

Canadian owners renting or selling U.S. real estate

Understanding key tax issues and potential strategies to minimize tax

Each year, many Canadian snowbirds escape the often long and cold winter by flocking to popular warm-climate destinations in the U.S. such as Florida and Arizona. While some snowbirds choose to rent a vacation or retirement home in the south, others choose to purchase their own U.S. real estate property. Purchasing your own property has its advantages; however, you may be surprised by the numerous tax requirements and other considerations that can substantially increase the complexity of owning real estate in the U.S.

This article focuses on the U.S. tax issues faced by Canadians who earn rental income from or who sell U.S. real estate. It highlights key income tax and estate planning considerations by addressing the following questions:

- What are my tax obligations if I rent or sell my U.S. property?
- Do I need to file a U.S. income tax return?
- Is there a potential for double tax?
- Are there any strategies available to minimize tax?
- What are the tax implications on my death?
- Is my Canadian Will and Power of Attorney adequate to cover my U.S. real estate property?

The information provided in this article is intended for Canadian individuals who are not U.S. citizens, green-card holders or residents and who are earning rental income that is investment income and not income from engaging in a U.S. trade or business. While some of the information may also apply to real estate ownership through a partnership, trust or corporation, this article does not address all of the considerations for ownership in these structures. Also,

U.S. states may have different income, estate, inheritance and transfer taxes laws. This article provides information on U.S. federal tax laws and does not provide information about U.S. state tax laws, unless otherwise stated.

Tax on rental income from your U.S. property

Canadians who earn rental income from U.S. real estate may be subject to U.S. income tax. There is an exception when the rent is earned from a U.S. vacation property that's rented for less than 15 days.

Rental income earned for investment purposes and not connected to a U.S. trade or business is taxable under the following two options.

Option 1: 30% withholding tax on gross rent with no requirement to file a U.S. tax return

You pay a flat 30% U.S. withholding tax on the gross rental income earned. The tenant or property manager reports annual rent collected on your behalf on Internal Revenue Service (IRS) Form 1042 – *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and Form 1042-S – Foreign Person's U.S. Source Income Subject to Withholding.*

With this option and a properly filed Form 1042-S, you do not file a U.S. income tax return and thus you do not have to incur the accounting costs associated with preparing a U.S. income tax return. However, you cannot deduct expenses related to the rental income in determining your U.S. tax obligation. If the tenant or property manager fails to properly withhold and file Form 1042-S, you must file a U.S. return and remit the 30% withholding tax.

For Canadian tax purposes, you are required to file a Canadian income tax return and pay Canadian tax on a net rental income basis. This means you report the gross rental income on your Canadian tax return, deduct rental expenses and pay tax on the difference. Since your Canadian tax is based on the net rental income, your Canadian tax liability may be much lower than the 30% U.S. withholding tax you pay on the gross rent. Further, you may be able to claim a foreign tax credit for the U.S. tax paid to reduce or eliminate double taxation. However, the foreign tax credit you can claim on your Canadian return cannot be greater than your Canadian tax liability on income from U.S. sources. As such, you may not be able to recoup the full 30% U.S. withholding tax paid.

This option may result in a higher overall tax than option 2 (discussed next) and may not be the most appropriate option financially. It may be appropriate only in cases where the tax differential is minimal, which may occur where you earn a large amount of rental income, have no mortgage interest expense and incur very low costs to maintain the property.

Option 2: File a U.S. non-resident tax return and pay tax on net rental basis

In order to pay tax on a "net rental basis" at graduated U.S. tax rates, you must elect to treat the rental income as income effectively connected with a U.S. trade or business and file a U.S. non-resident income tax return (Form 1040NR). Similar to the Canadian tax rules, you may deduct expenses such as property taxes, mortgage interest, insurance, management fees and utilities to determine your net rental income.

> Canadians who earn rental income from U.S. real estate may be subject to U.S. income tax.

Under this option, you are not subject to U.S. withholding tax but you may be required to make estimated tax payments. And, U.S. tax law imposes a mandatory requirement to claim depreciation with special rules regarding the ability to claim rental losses.

A loss from rental property is considered a passive activity loss and can only be deducted against passive activity income, such as other rental income or gains from the sale of rental property. If a loss cannot be claimed in the current year, it can be carried forward and potentially used to offset rental income in future years and capital gains triggered in the year the property is sold. The passive activity losses can be deducted in full when the property that generated the losses is disposed. A detailed discussion of these rules is beyond the scope of this article.

The benefit under this option is that your net rental income is subject to U.S. tax at graduated U.S. tax rates. This tax may be lower than the amount of withholding tax you would otherwise have to pay on the gross rental income under option 1. The election applies to income from all U.S. real property, including capital gains, for all future tax years and can only be revoked with the consent of the IRS.

For Canadian tax purposes, there's a greater chance with this option that the foreign tax credit claim will be sufficient to recoup the U.S. tax paid. As a result, you may pay a lower overall tax with option 2 than with option 1, even if you factor in the cost of filing a U.S. non-resident tax return.

Net rental basis – U.S. tax forms and deadline

To avoid having withholding tax applied to the gross rent, you must complete IRS Form W-8ECI –*Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States*.

This form is provided to your tenant or the U.S. agent acting as the property manager. It is not sent to the IRS. The form releases your tenant or property manager from having to withhold U.S. tax on the rental payments. The property manager reports annual rent collected on your behalf on IRS Form 1042 and Form 1042-S.

You must file a U.S. non-resident income tax return (Form 1040NR) and attach a declaration to file on a net rental basis.

The declaration must include the following information:

1. That you are making the choice.
2. The U.S. tax law (code section) or the tax treaty that permits the election.
3. A complete list of all of your real property, and any interest in real property, located in the U.S.
4. The extent of your ownership in the property.
5. The location of the property.
6. A description of any major improvements to the property.
7. The dates you owned the property.
8. Your income from the property.
9. Details of any previous choices and revocations of the real property income choice.

Your Form 1040NR U.S. non-resident tax return must also include Schedule E – *Supplemental Income and Loss*. The U.S. return must be filed even if the net rental calculation results in a rental loss.

The tax return filing due date is generally June 15 of the following year; however, regardless of the filing deadline, any balance of tax owing must be paid to the IRS by April 15 of the following year to avoid late interest charges. An earlier filing due date of April 15 would apply where you earn compensation income from U.S. sources subject to withholding tax. The filing deadlines can be extended to October 15 if IRS Form 4868 – *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, is filed no later than the original due date.

If you miss the April/June 15 deadline, there is an additional 16-month grace period to file a return on a net rental basis. Beyond the 16-month grace period, you will no longer be eligible to elect to pay on a net rental basis and the 30% withholding tax on gross rental income (plus any penalties and interest) will apply for that tax year.

Tax on sale of your U.S. property

When a Canadian sells their U.S. real estate, the following tax implications will apply:

> The purchaser of your property is obligated to act as a withholding agent for the IRS.

i) **U.S. withholding tax:** Unless certain exceptions (discussed later) are met, the gross sale proceeds will be subject to a 15% U.S. withholding tax at the time of transfer; and

ii) **U.S. non-resident income tax return/Canadian income tax return:** A net taxable capital gain, depreciation recapture and an un-recaptured 1250 gain as determined under U.S. income tax laws are reported on a U.S. non- resident income tax return (Form 1040NR). Net taxable capital gains and recapture determined under Canadian tax laws are reported on a Canadian income tax return.

U.S. withholding tax

The purchaser of your property is obligated to act as a withholding agent for the IRS. They must file IRS Form 8288 – *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests* to report and remit withholding tax to the IRS on the amount the seller will receive on the sale of property. There are exceptions to the withholding tax requirements, discussed in the following section. Included in the filing of Form 8288, the purchaser must attach IRS Form 8288-A – *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*, for each person for whom tax was withheld. The purchaser is not required to provide you, the seller, with a copy of Form 8288-A. The IRS will approve and stamp it first and will then send a copy to you. You can then use this copy to claim the withholding taxremitted on your U.S. non-resident tax return. The purchaser is required to file these forms with the IRS by the 20th day after the date of transfer.

Exceptions to the requirement to withhold tax

If the following exceptions are met, the requirement of the purchaser to withhold tax on the proceeds of the sale may be reduced or waived:

Exception 1: No withholding tax if sale price is US$300,000 or less and property is used as a residence

The requirement to withhold tax is waived if you sell your U.S. real property for US$300,000 or less and the purchaser intends to use the property as a residence. The purchaser or a member of their family must have definite plans to reside at the property for at least 50% of the number of days the property is used by any person during each of the first two 12-month periods following the date of transfer. The days the property will be vacant are not counted as days. This exception only applies if the purchaser is an individual.

Exception 2: 10% withholding tax if sale price is greater than US$300,000 and less than US$1 million and property is used as a residence

If the gross sales proceeds are greater than US$300,000 but do not exceed US$1 million, the required withholding tax rate of 15% is reduced to 10%, provided the individual who buys the property intends to use the property as a residence.

Exception 3: Reduced withholding tax if approved by IRS

If you expect your tax liability on the capital gain will be less than the amount of withholding tax that must be withheld on the gross sales proceeds, you can ask the IRS to reduce or eliminate the amount of U.S. withholding tax required. The request is made by filing IRS Form 8288-B – *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*, on or before the closing date of the sale. If the IRS grants your application, you will receive a withholding certificate that you can provide to the purchaser, which will indicate the amount of tax that should be withheld by the purchaser instead of the default required withholding tax. If the application is still pending with the IRS on the date of transfer, the default withholding tax must be withheld by the purchaser. The amount withheld must be reported and paid within 20 days following the day on which a copy of the withholding certificate or notice of denial is mailed by the IRS. The purchaser should give you any excess amounts of the sale proceeds withheld that are not required to be remitted to the IRS.

U.S. non-resident tax return to report the sale

You will need to file a U.S. non-resident income tax return (Form 1040NR) to report the sale of your U.S. real estate. A portion of the sale proceeds, based on the depreciation of the building, may be classified as depreciation recapture and/or as an un-recaptured section 1250 gain. The remaining balance of your sale proceeds is reported as a capital gain. Any unused capital losses or rental losses carried over may be used to offset the capital gain. A discussion of the calculation of depreciation recapture and un- recaptured section 1250 gains is beyond the scope of this article; however, the taxation of these amounts is discussed in the next section.

For Canadian tax purposes, the amount of depreciation you can claim on U.S. rental property will likely be different than the depreciation you would claim on your U.S. tax return. Canadian tax law does not impose mandatory depreciation. Therefore, if you have chosen not to claim it, you would not realize any recapture when you sell your property.

For U.S. tax purposes, a capital gain triggered on property held for longer than 12 months prior to its disposition is subject to a preferential long-term U.S. capital gains tax rates.

In order to report the capital gain or loss in Canadian dollars, the proceeds and adjusted cost base (ACB) are converted to Canadian dollars based on the relevant Canada-U.S. exchange rate at the time the proceeds are received, the property was purchased and capital improvements were made. Fluctuations in the exchange rate will result in the inclusion of exchange gains or losses in determining the capital gain or loss for Canadian tax purposes.

Tax rates on capital gains and recapture

For U.S. tax purposes, a capital gain triggered on property held for longer than 12 months prior to its disposition is subject to a preferential long-term U.S. capital gains tax rates (the maximum tax rate is 20%). If the U.S. property is held for under 12 months, a short-term capital gain is triggered and is taxed as ordinary income. Ordinary income is subject to tax at U.S. graduated tax rates (the maximum tax rate is 37%). There may also be a U.S. state income tax levied. For rental property, depreciation recapture is taxed as ordinary income and un-recaptured section 1250 gains are subject to a maximum U.S. tax rate of 25%.

For Canadian tax purposes, only 50% of capital gains are taxable. The taxable gain and any recapture are subject to tax at Canadian graduated tax rates (the maximum tax rate depends on your province/territory of residency).

Excluding capital gains on sale of principal residence

For U.S. tax purposes, each taxpayer may exclude up to US$250,000 of the capital gain on the sale of a residence that qualifies as their principal residence (i.e. residence you own and use as your main home for at least two out of the prior five years prior to the sale). Typically, a Canadian's main home is located in Canada and generally would not qualify to claim the exclusion on their U.S. tax return when they sell their U.S. vacation home.

For Canadian tax purposes, the entire capital gain may be exempt if you designate the property as your principal residence and the property qualifies for the principal residence exemption under Canadian tax rules. To qualify, you must own the property and ordinarily inhabit it. The property does not have to be your main home. Therefore, it is possible that both your home in Canada and your U.S. vacation property may qualify as a principal residence for Canadian tax purposes.

Keep in mind that you can only designate one property as your principal residence for a particular year. Therefore, when you own two properties at the same time, you must carefully consider the best method to apply the principal residence exemption. For example, if your U.S. vacation property qualifies as a principal residence for Canadian tax purposes but not for U.S. tax purposes, you can only exclude the entire gain from Canadian tax. Since you will still have to pay U.S. tax on the gain, it may be more tax-efficient to save the Canadian exemption on the future disposition of your personal home in Canada. It may also make sense to claim only a portion of the Canadian principal residence exemption on the U.S. vacation property to trigger enough Canadian tax necessary to claim a foreign tax credit to fully recoup the U.S. tax paid. The balance of the principal residence exemption can be saved and used to exempt the gain on the future disposition of your personal residence in Canada.

Potential for double tax on jointly owned property

The Canadian income attribution rules may be triggered when a U.S. rental property is purchased with funds provided by one individual and title to the property is registered as joint tenants with right of survivorship (JTWROS) with another individual. For example, assume an individual uses their own funds to purchase a property. They choose to register the property jointly with their spouse. For Canadian tax purposes, the individual who contributed all of the funds to make the purchase is taxed on the rental income earned and capital gains triggered if the property is sold.

For U.S. income tax purposes, it's important to confirm with your qualified tax advisor whether the reporting of rental income and capital gains will match the Canadian tax treatment. This may depend on which U.S. state the U.S. real estate property is located. If the reporting of income and gains in Canada differs from the U.S., it is possible for double tax to result because you cannot claim foreign tax credits on your Canadian tax return for U.S. income tax incurred by another individual.

Holding property as JTWROS does offer the benefit of avoiding probate upon the death of the first spouse. The probate process may be costly and take a significant amount of time. Where income tax issues are not significant, JTWROS may be a viable alternative to holding title to the property in sole name. When tax issues due to differences in tax treatment are significant, you may consider severing property ownership held as JTWROS, based on each tenant's contribution, and to hold your interest as tenants in common.

The Canadian income attribution rules may be triggered when a U.S. rental property is purchased with funds provided by one individual and title to the property is registered as joint tenants with right of survivorship (JTWROS) with another individual.

U.S. gift and estate tax issues (discussed later) must also be considered for property registered as JTWROS.

Other income tax considerations

Requirement for Individual Taxpayer Identification Number (ITIN)

You will need to have an ITIN to file a U.S. non-resident income tax return, whether you are filing to report rental income or to report the sale of U.S. property. The purchaser of your property will require an ITIN in order to complete the required reporting on the IRS Forms 8288 and 8288-B discussed earlier. If you do not already have one, you can apply for one using IRS Form W-7 – *Application for IRS Individual Taxpayer Identification Number*.

Tracking time spent in the U.S.

Whether you own a property in the U.S. or not, if you travel to the U.S. frequently, your physical presence in the U.S. may create U.S. income tax filing obligations, including the requirement to file a U.S. income tax return and other disclosures. This topic is discussed in greater detail in a separate RBC article. For more information, ask your RBC advisor for a copy of the article that discusses U.S. residency.

Canadian foreign income verification reporting

Canadian snowbirds with U.S. vacation properties used primarily to earn rental income may be subject to Canadian foreign reporting rules. The rules require Canadians who hold certain types of foreign property with a cost in excess of C$100,000 at any time during the taxation year to disclose certain information related to the foreign property on Form T1135 – Foreign Income Verification Statement.

U.S. vacation properties that are primarily held for personal use are exempt from Form T1135 reporting. The

Canada Revenue Agency generally considers primarily to mean more than 50%. Generally, a U.S. vacation property that's not rented out or that's only rented for a small portion of the year with no real profit motive may be considered personal- use property and exempt from the reporting. However, if the U.S. vacation property is used primarily as a rental unit, for example, the property is rented out for eight out of 12 months at market rates, the property may need to be reported on the T1135.

Estate planning considerations

U.S. gift and estate tax

Canadians may be subject to U.S. gift tax but only when making gifts of "U.S. tangible property" (such as U.S. real estate, jewellery, cars and artwork located in the U.S.). The value of the gifts in a year must exceed certain annual thresholds before U.S. gift tax will apply.

In general, you may trigger U.S. gift tax by adding someone else on title to U.S. tangible property you own or purchase. For example, you're considered to have made a gift of half the value of U.S. real estate you purchase when you register title to the property as JTWROS with someone who has not contributed any funds to make the purchase.

U.S. gift tax rules may be applied differently where a spouse is involved. The gift tax laws that apply when a joint tenancy is created with a non-U.S. citizen spouse will depend on whether the joint tenancy was created before July 14, 1988. A joint tenancy created after this date does not result in a gift at the time it's created. A gift is made upon the termination of the joint tenancy other than by death (e.g. upon the sale of the property or change in ownership structure) if the sale proceeds are received by the non- U.S. citizen spouse and they are in excess of their relative contribution to the purchase of the property.

If you pass away owning "U.S. situs assets" such as stock of a U.S. corporation or U.S. real estate, you may be subject to U.S. estate tax. For assets held in JTWROS, the entire value is included in the estate of the first joint tenant to pass away, unless the estate can prove the survivor provided consideration for their share of the property. There are several strategies that Canadians may use to minimize their exposure to U.S. estate tax. Some of the common strategies include gifting intangible assets or selling the U.S. situs assets prior to death, purchasing life insurance through a trust to fund the estate tax liability, using a Canadian trust or partnership to purchase U.S. real estate, or using a non- recourse mortgage to limit the value of the U.S. real estate that would be subject to U.S. estate tax. For more information on these strategies, ask your RBC advisor for two separate articles; one discusses U.S. estate tax exposure for Canadians and the other specifically addresses U.S. estate tax for Canadians owning U.S. real estate.

Will planning

It's important to ensure you have a valid Will that properly addresses your wishes with respect to your U.S. real estate. Although a Canadian Will may be adequate, complexities may arise due to potential clashes between the differing Canadian and U.S. succession laws. To minimize this risk, you could consider executing

a separate Will (tailored to the U.S. state where the U.S. real estate is located) to deal specifically with your real estate and other assets located outside of Canada. When executing a separate U.S. Will, it's important to ensure it doesn't conflict or revoke your Canadian Will. Speak to a qualified cross-border legal advisor regarding multiple Wills.

As an alternative to a U.S. Will, the property can be held by a revocable trust. However, a transfer of appreciated property to a revocable trust may result in Canadian tax. In addition, the assets in the trust will be subject to a deemed disposition on the 21st anniversary of the settlement of the trust. Speak with a qualified legal advisor to determine if setting up a trust to hold your U.S. real estate makes sense for your circumstances.

Power of Attorney (POA)

Consider whether you require a separate POA in the U.S. state where your real estate is located in order to deal with the property in the event of your incapacity or disability. This is particularly important in the case of a rental property held in sole name. A separate POA in the U.S. may be necessary to ensure the property continues to be managed if or when you are no longer able to do so. POAs are legislated at the state level in the U.S.

A Canadian POA may not be valid in the U.S., as it may not comply with U.S. state specific formal requirements. Speak to a qualified cross-border legal advisor for advice on whether you require a separate POA in the state where your U.S. real estate or other U.S. property is located.

It's important to ensure you have a valid Will that properly addresses your wishes with respect to your U.S. real estate. Although a Canadian Will may be adequate, complexities may arise due to potential clashes between the differing Canadian and U.S. succession laws.

Be prepared

Whether you already own U.S. real estate or are considering making a purchase, there are significant tax, financial and estate planning implications to consider. It's important to familiarize yourself with these issues so you know what to expect and how to prepare. Speak to your qualified cross-border tax and legal advisors for advice if you own or are planning to acquire U.S. real estate.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.